EMSTONE ADVISERS, LLC

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Anthony J Basile, *Portfolio Manager*
Gail M Habecker, *CFA, Economist*
Folu Abiona, *Portfolio Manager*
Sundar Kuttalingham, *CFA, CAIA, Sr. Analyst*

Numbers in the News

Indicator	09/30 Value	Versus 06/30
3-month T-bill	0.03%	-1 bps
2-yr T-note yield	0.28%	+3 bps
10-yr T-note yield	1.49%	+2 bps
Yield Curve (2-10yr)	1.21%	-1 bps
ICE BofAML High Yield (YTW)	4.00%	+23 bps
S&P 500 Index	4307.5	+0.23%
Dow Jones Index	33,843.9	-1.91%
Retail Sales (Aug vs. May)	$618.7bil	-0.23%AR
ISM Manufacturing	61.1	+1.2
Payroll Employment (000)	+194	+1651
CPI last 12 months (Aug vs. May)	+5.3%	+0.30pp
Core CPI last 12 months (Aug vs. May)	+4.0%	+0.20pp
Personal Consumption Deflator (PCD) last 12 mo (Aug vs. May)	+4.3%	+0.30pp
Core PCD Last 12 mo (Aug vs. May)	+3.6%	+0.17pp

Bloomberg Barclays Bond Index Returns

	Third Quarter	12 Months
Aggregate	0.05%	-0.90%
Government/Credit	0.04%	-1.13%
Intermediate G/C	0.02%	-0.40%
Intermediate A+ G/C	0.00%	-0.95%
1-3 Year Govt	0.07%	0.03%
Municipal Bond	-0.27%	2.63%

bps = basis points (0.01%)
pp = percentage points
AR = annual rate
NC = no change

Data obtained from various market and government sources by Stoneridge PMG Advisors, LLC. For additional information, please contact our office.

As of: Oct 8, 2021

During the first half of 2021, the U.S. economy grew robustly and surpassed its pre-pandemic output level. Personal consumption was the main driver of growth, surging at double digit rates. As we entered the second half of the year, personal spending shifted from goods to services. Foot traffic was brisk in malls and restaurants. Pent up travel demand helped revive the domestic leisure and hospitality sector. However, as the quarter progressed, the delta-variant virus reared its head. The combined impact of rising inflation and the resurgent virus shook consumer confidence. The volume of people dining out and attending live events started declining, and personal consumption slowed. As a result, the economy decelerated in the third quarter.

Labor Market Dynamics ❖ Though economic activity rebounded sharply, the job market recovery came in fits and starts. After adding almost two million jobs during the prior two months, the pace of job creation slowed in August and September. The total payroll was still well below its pre-pandemic level and millions remained jobless when the federal unemployment benefits expired. Yet, the labor market betrayed signs of tightness. The V-shaped recovery spurred the number of job openings to a historically high level. But open positions remained hard to fill. During the monthly surveys of small business owners conducted by the National Federation of Independent Businesses, almost half the respondents reported difficulties finding workers. They also stated that supply chain disruptions were impacting their businesses.

Supply Chain Disruptions ❖ The delta-variant virus disrupted factories and ports across Asia. As a result, manufacturers grappled with shortages of parts and materials in addition to rising commodity prices and transportation costs. Electronics device makers could not fulfill customer orders and automakers had to partially shut down factories due to a shortage of semiconductor chips. The disruptions were not limited to industrial supply chains. Severe drought impacted food supplies as well. Reflecting these factors, producer price inflation climbed sharply higher from year-ago levels.

The Inflation Debate ❖ While there was no letup in producer price inflation, the measure of inflation from the consumer perspective appeared to be leveling off. Some components of inflation, such as the price of used cars and airfares, may indeed be transitory as the Fed would like us to believe. But what about wages and the price of shelter? Major retailers have raised the minimum wage to fifteen dollars per hour. Strong demand and low mortgage rates have contributed to asset-price inflation in the housing market. Many first-time home buyers were not only priced out of the market but also faced surging rental inflation. Rising rents and wages can exert prolonged upward pressure on the CPI. It remains to be seen how policy makers will respond should inflation remain elevated.

Policy Direction ❖ Fiscal policy has played an outsized role in the current cycle. Even as the pandemic stimulus programs fade, fiscal policy is expected to remain supportive of growth. Notwithstanding the twists and turns of the

fiscal process, new spending initiatives are being debated. With regard to monetary policy, the Fed is on a new policy framework that was unveiled last year. According to the new strategy, the Fed would allow inflation to temporarily overshoot while seeking its "maximum-employment" goal. The strategy will face its test in the coming months as the Fed prepares to take away the punchbowl while the party is still on. So far, the Fed has managed to take the initial steps toward winding down its quantitative-easing program without rattling the markets as happened in 2013.

Financial Market Reaction ❖ After rising sharply in the first quarter of 2021 in line with the robust economic recovery, the Ten-year Treasury yield shrugged off inflation readings and drifted steadily downward as if searching for a floor which it seemed to find in August. Lower bond yields helped justify higher asset prices. Home prices rose sharply, and equity market indices made fresh new highs in July and August.

At its annual Jackson Hole Economic Policy Symposium in August, the Fed communicated its intention to start dialing back its liquidity support without causing any ripple on the bond market. Perhaps, the bond market had already anticipated this pivot toward a tightening cycle. Since bottoming in August, the Ten-year yield shifted to an upwardly tilting trajectory while awaiting more details from the Fed. Following the Federal Open Market Committee meeting in late September, the Fed signaled that tapering of asset purchases could begin this year so the program could end by mid-2022. This sets the stage for potential rate hikes shortly thereafter. In reaction, the ten-year yield moved distinctly higher.

Near-term Outlook ❖ The growth surge of the first half of 2021 was driven by fiscal stimulus which pulled demand forward. Hence, a slowdown was to be expected in the third quarter. But the pandemic flareup was also a factor. The economy likely slowed to approximately 3.5% during the third quarter. As the current wave of the pandemic subsides, we can expect growth momentum to pick up in the fourth quarter.

Fixed Income Update ❖ The U.S. Treasury yields rose for most maturities during the third quarter, with the exception of the 30-year Treasury. The slope of the Treasury yield curve, 2-year vs. 10-year, was 121 basis points at the end of third quarter – mostly unchanged from the level that prevailed at the end of the second quarter. The 5-year yield rose 8 basis points and the 10-year yield rose 2 basis points to 0.96% and 1.49% respectively, while the 30-year bond fell 5 basis points to 2.04%. Rising inflation as well as concerns related to the Federal Reserve's possible tapering later this year of the purchases of Treasuries and mortgage-backed securities has the bond market on edge. Much will hinge on upcoming economic and employment data. Economic growth, which is expected to have slowed in Q3, has helped keep the 10-year Treasury yield in our previously forecasted range of 1.25% to 1.75% at least for now.

Corporate credit produced a total return of 0% with -0.15% in excess return, marginally underperforming U.S. Treasuries. Most sectors produced negative excess and total returns. The low level of sector returns (mostly below 0.5%) either positive or negative was instructive. This was in sharp contrast to 2Q21's multi-percentage all positive returns. It illustrates that further contraction of Investment Grade credit spreads is a challenge. It also explains why weaker credits again outperformed in 3Q21. Pandemic-related themes have been unwinding. Most sectors are heading toward normalization. Certain logistical constraints remain but none are producing the dramatic sector gains/losses of the last 18 months. However, YTD and 12-month excess returns remain decent at 1.74% and 5.47% respectively.

The best performer in 3Q (with excess return of 1.17%) was subordinated debt issued by banks as the prospect of higher rates lifted the outlook for banks. Conversely, the gaming sector produced the worst return (excess return of – 1.26%). This was due to the Chinese government crackdown on technology companies. In pursuing its social domestic policies, China ruffled pockets of the credit market during the quarter. As the quarter end approached, concerns about Evergrande, the over-levered Chinese real estate giant hit the headlines. Fortunately, the market shrugged it off, assessing the risk of global contagion as negligible.

A global energy supply crunch emerged in late September. Crude oil (WTI) topped $78 per barrel and the UK reported a dire shortage of truck drivers for fuel delivery. Coal prices are also elevated due to flooding in China's mining regions. It remains to be seen whether these pressures result in a meaningful impact on credit spreads in the quarter ahead. In Europe, low stockpiles of natural gas have caused a huge price spike ahead of winter. With the Fed tapering expected in the near term, we are entering a period of transition. We expect the transition to bring greater volatility in credit markets.